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No. 215

# In the Supreme Court of the United States

OCTOBER TERM, 1932

E. G. PALMER, PETITIONER

*v.*

MRS. AGNES B. MCGRAWL BENDER, ADMINISTRATRIX OF THE ESTATE OF JACOB O. BENDER, LATE COLLECTOR OF INTERNAL REVENUE FOR THE DISTRICT OF LOUISIANA

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT*

**BRIEF FOR THE RESPONDENT**

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# In the Supreme Court of the United States

OCTOBER TERM, 1932

No. 215

E. G. PALMER, PETITIONER

*v.*

MRS. AGNES B. MCGRAWL BENDER, ADMINISTRATRIX of the Estate of Jacob O. Bender, Late Collector of Internal Revenue for the District of Louisiana

*ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT*

## BRIEF FOR THE RESPONDENT

### OPINIONS BELOW

The opinion of the District Court for the Western District of Louisiana (R. 98–116) is reported in 49 F. (2d) 316. The opinion of the Circuit Court of Appeals (R. 424–429) is reported in 57 F. (2d) 32.

### JURISDICTION

The judgment of the Circuit Court of Appeals was entered March 26, 1932. (R. 429.) A petition

for rehearing filed April 12, 1932 (R. 430), was denied April 23, 1932 (R. 430). The petition for certiorari was filed July 12, 1932, and was granted October 17, 1932. (R. 430.) Jurisdiction of this Court rests upon Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

### QUESTION PRESENTED

Whether two certain instruments, each executed by a partnership of which petitioner was a member, effected a sale or assignment of oil and gas leases or were merely subleases upon the basis of which the partnerships would be entitled to allowances for depletion of their respective interests.

### STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved will be found in the Appendix, *infra,* pp. 28–35.

### STATEMENT

This case is one of forty-five related cases which were by stipulation consolidated for trial. (R. 355–360.) The case was tried to the court without a jury (R. 26) and was submitted upon stipulations and agreed statements of evidence. (R. 92, 178, 320, 322, 324, 335.) The District Court made certain findings of fact (R. 28–55, 59–90), which may be summarized as follows:

The petitioner was a member of two partnerships known as the J. E. Smitherman, Special Account, and the George O. Baird Partnership.

**J. E. Smitherman, special account**

Early in 1919, J. E. Smitherman and a group of associates, including petitioner, entered into a contract with certain citizens of Haynesville, Louisiana, wherein it was agreed that if the latter would lease to Smitherman and his associates 15,000 acres of designated land in the vicinity, Smitherman and his associates would pay a bonus of 50 cents per acre for such leases and would drill a test well on the property within eight months. A partnership was thereupon formed composed of Smitherman and associates, known as "J. E. Smitherman, Special Account," in which petitioner had a 15 5/6 per cent interest. The partnership obtained leases on about 26,000 acres of land in the vicinity of Haynesville in the name of Smitherman, in whose name all subsequent contracts were made. (R. 29–30.)

During 1919, 1920, and 1921 several wells were drilled, but no oil was discovered until March 30, 1921, when a producing well was completed in a discovery area located on land covered by four of the leases. Exhibits H (R. 198), I (R. 204), J (R. 209), and K (R. 213). (R. 31.)[1] This well

[1] These leases provide that they are for the purpose of exploiting the land and producing minerals therefrom. Each lease granted the exclusive right of "drilling and operating thereon for oil or gas and other minerals." The lessee is given the right to begin drilling within one year, with the right to a limited number of extensions of time for six-month periods upon the payment of 50 cents per acre on or

had an estimated daily production of 7,500 barrels and cost approximately $25,000 to complete. (R. 51.)

On April 23, 1921, the partnership by an instrument in writing transferred to the Ohio Oil Company their interest in 120 acres of the 160-acre tract on which the producing well was located.[2] The

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before the commencement of each six-month period. Upon the discovery of oil or gas the lessor is to receive one-eighth of the oil and $300 per year for each gas well.

[2] This instrument covers three forties (120 acres) of a quarter-section (NW.¼, Sec. 14, Township 23 North, Range 8 West, Claiborne Parish, La.), embraced in the lease from Anna Taylor et al., to Smitherman. (Exhibit H. R. 198, 199.) The partnership by an instrument executed April 21, 1921, transferred a one-half interest in the other forty acres of the above quarter-section to the Gilliland Oil Company for a cash payment of $600,000. (R. 39–41.) That instrument was executed pursuant to an agreement or contract of sale dated April 18, 1921, providing for the sale and assignment of a one-half interest in the leases for said forty acres, and also of a one-half interest in a number of other leases in consideration of $150,000 and a half interest in certain property owned by the grantee. (Exhibit M, R. 221–227.) The instrument transferring the one-half interest in the other leases was executed April 21, 1919. (Exhibit R, R. 228–238.) When the present suit was brought in the United States District Court petitioner claimed that the instrument transferring the one-half interest in the forty acres referred to above was a sublease and that he was entitled to deduct depletion from the $600,000 received thereunder. This claim was abandoned at the trial, petitioner conceding that the instrument was clearly an assignment. (The fact of the abandonment of this issue does not appear in the printed record, but is set out in petitioner's brief in the Circuit Court of Appeals, pp. 17–18.)

pertinent parts of the instrument are as follows (Exhibit N, R. 31–33):

> * * * in consideration of the sum and price hereinafter set forth, he [Smitherman] has and does by these presents sell, assign, set over, transfer, and deliver, without warranty or recourse, but with full subrogation of all rights and actions of warranty, unto The Ohio Oil Company * * * the following-described property * * *:
>
> * * * * *
>
> To have and to hold unto The Ohio Oil Company, its successors and assigns forever, subject to the performance of the terms and covenants in said mineral lease, and payment of rentals and royalties as stipulated in said mineral lease, in so far as same covers and effects that portion herein assigned.
>
> To have and to hold unto the said The Ohio Oil Company, its successors, and assigns for and in consideration of the sum and price of three million dollars ($3,000,000) cash in hand paid, the receipt of which is hereby acknowledged, and full discharge and acquittance granted therefor, and the obligation of the said The Ohio Oil Company, to pay over and deliver unto the Assignor, his successors and assigns, the sum of One Million Dollars ($1,000,000) out of one-half of the first oil produced and saved from said above-described premises, and subject to the further obligation of the said assignee, its successors and assigns, to pay

over and deliver unto said assignor, his heirs, executors, and assigns, the equal one-eighth (⅛) of all oil produced and saved from the above described premises as an excess royalty, whether produced under the present lease contract or under any extension, renewal, or other contractual obligations entered into by and between the said Assignee, its successors or assigns, with the Lessor, his heirs or assigns.

It is agreed and understood that if the said The Ohio Oil Company, its successors or assigns, should elect to manufacture casing head gasoline from the premises herein assigned, that the said Smitherman, his heirs and assigns, shall share in the profits derived from the one-eighth (⅛) thereof, provided he contributes a like proportion of the costs and expenses of building the plants and equipping same for the purpose of manufacturing said casing head gasoline, and a like proportion of the expenses of manufacturing same.

The recited consideration of $3,000,000 was paid by The Ohio Oil Company, and the partnership also received the additional $1,000,000 provided for in the agreement. (R. 74.)

On the same date, by another instrument the partnership transferred to The Ohio Oil Company, one hundred and twenty-eight leases, including specifically parts of the land leased by Exhibits "H" and "J," *supra* (R. 275, item 92; R. 272, item 82; R. 285, item 125), and also covering by a general

provision all leases other than those listed owned by the partnership in the townships and ranges named, except that portion of the area covered by the lease from Anna Taylor et al., as to which previous assignments had been made to The Ohio Oil Company and the Gilliland Oil Company. (R. 286.) The consideration for this transfer was a present cash payment of $370,000 and an obligation to pay to the assignor one-eighth of the oil produced and saved, "whether under the present lease contracts herein assigned, or under any extensions, renewals, or other contractual obligations or covenants entered into by" The Ohio Oil Company, its successors or assigns, with the present lessors, their heirs, and assigns. (R. 287.) (Exhibit "Q," R. 249–288.) No claim for a depletion allowance has been made by petitioner with respect to payments received under this instrument.

Also, on April 23, 1921, the Ohio Oil Company addressed to Smitherman a letter reading as follows (R. 38–39, 75, 248–249):

THE OHIO OIL COMPANY,
*Shreveport, La., April 23, 1921.*

Mr. J. E. SMITHERMAN,
*Shreveport, Louisiana.*

DEAR SIR: With reference to the act of assignment executed this day by you unto The Ohio Oil Company transferring and conveying unto said company one hundred twenty-eight oil, gas, and mineral leases covering and affecting lands situated in Claiborne Parish, Louisiana, in Twp. 22

North, Ranges 7 and 8 West, and in Twp. 23 North, Ranges 6, 7, and 8 West, this writing is addressed to you for the purpose of expressing the agreement of this company that if at any time hereafter we shall elect to release, surrender, or cancel all or any part of any one or all of said leases, then before effecting such release or cancellation such lease or leases or part or parts thereof will be first offered to you, and if you shall request it, same will be reassigned or reconveyed to you by this company instead of being released or surrendered direct to the lessors.

Yours very truly,

THE OHIO OIL COMPANY,

By J. K. KERR, *Vice President.*

JKK: C.

On July 12, 1921, Smitherman and the Ohio Oil Company entered into what they termed a working agreement, under which the Ohio Oil Company was to gather, store, and dispose of the one-eighth of the oil produced and saved, which was to be paid to Smitherman under the instrument of April 23, 1921, transferring the lease covering the 120-acre area. (R. 75–78; Exhibit "O," R. 245–247.)

**George O. Baird partnership**

In 1919, Baird, acting for the partnership, acquired an oil and gas lease of a certain area of land, then unproved, in Claiborne Parish, Louisiana, known as the "Langston Lease." (R. 52, 93.) The partnership drilled a well on the property which

resulted in the discovery of oil on August 23, 1919. The Commissioner of Internal Revenue recognized their right to a discovery revaluation and found the unit value for depletion purposes to be $1.3859 per barrel. (R. 94.)

On November 16, 1921, Baird, acting for the partnership, entered into a written contract with the Gulf Refining Company of Louisiana with respect to the lease. (R. 96.) Under this contract the Gulf Refining Company obligated itself to take possession of the "lease," to equip and operate the wells for the production of oil, at its entire expense, and to pay all taxes. Of the oil produced, it was to retain forty per cent, out of which it was to pay the royalty of one-eighth (⅛) of all oil produced to the lessor, and to pay one-twenty-fourth (1/24) to Baird for a term of three years, after which the payment to Baird was to be one-thirty-second (1/32nd) of all oil produced. The agreement recited that the Gulf Refining Company had loaned to Baird $350,000, on the security of the lease, without any personal liability and without interest. Sixty per cent of the oil produced was to be delivered to Baird (free from any claim on account of the loan of $350,000) until he had received $325,000 therefrom, or until a period of thirty months elapsed; after which the Gulf Refining Company might reimburse itself from the sixty per cent of the oil for the loan of $350,000. Baird agreed that after the sixty per cent of the oil had produced said two sums aggregating $675,000, he

would sell, assign, and convey to the Gulf Refining Company the lease in its entirety; and as security for the performance of this agreement Baird contemporaneously executed an assignment of the entire interest in the lease which was to be placed in escrow and delivered to the Gulf Refining Company when it should have performed the obligations set out and made a consideration for the assignment. (Exhibit "Y", R. 313–318.)

As provided in the contract, the Gulf Refining Company took possession of the property, and a deed was executed by Baird and deposited with an escrow agent agreed upon by both parties, to be delivered under the conditions named in the contract. The deed was delivered by the escrow agent to the Gulf Refining Company some time in 1927. (R. 89, 96.)

The $350,000, referred to in the contract as a loan, was not paid to the partnership, but was at the direction of Baird paid by the Gulf Refining Company to one Munhall, in compliance with the terms of a judgment of a district court of Louisiana resolving or rescinding a prior contract to sell the Langston Lease to one Flannery, Munhall's assignor. Flannery had paid to the partnership in 1919 a net sum of $350,000 on account of the purchase price, but failed to pay the balance. Baird brought an action in the State court to set aside the contract, and obtained a judgment setting aside the contract as of its date and freeing the property of any claim or interest of Flannery or his as-

signs—the judgment to become operative upon the payment to Munhall of said sum of $350,000. (R. 96, 290, 309–311.)

The total remaining unreturned costs of the Langston Lease to the partnership at the date of the transfer to the Gulf Refining Company on November 16, 1921, for both depletable and depreciable property, was $96,114.90. (R. 320.)

Petitioner reported as income for 1921 his distributive share of sixty per cent of the oil received by the George O. Baird partnership from the Gulf Refining Company under the contract, but he made a deduction for depletion based upon the discovery value previously determined by the Commissioner of Internal Revenue. Petitioner also reported as income for 1921 his distributive share of the income of the partnership, J. W. Smitherman, Special Account, received under the contracts with the Ohio Oil Company and the Gilliland Oil Company transferring leases or interest in leases in the discovery area (Exhibit N, R. 242–244; Exhibit L, R. 217–221), and deducted depletion on a claimed discovery value. For 1922 petitioner similarly reported his distributive share of the income of the two partnerships and claimed corresponding deductions for depletion. These deductions were disallowed by the Commissioner.[3] (R. 51–53, 90, 97, 152–155.)

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[3] Petitioner has since conceded that he is not entitled to depletion on the sums received under the contract with the Gilliland Oil Company. (See note 2, *supra*, p. 4.)

This disallowance and certain other adjustments resulted in the determination of deficiencies in petitioner's income tax for 1921 of $129,138.75, and for 1922 of $38,071.17, a total of $167,209.92. (R. 53.) This sum and interest thereon, amounting to $212,937.80, was assessed against petitioner and paid by him under protest on January 4, 1927. (R. 53–54.) After rejection of claims for refund, the present suit was brought to recover the amount paid. One issue, not involved here, was decided in petitioner's favor and judgment was entered for him in the amount of $16,723.78.[4] (R. 127.) The Circuit Court of Appeals affirmed the judgment of the District Court. (R. 429.)

## SUMMARY OF ARGUMENT

In Louisiana, as in other states, a lessee may assign his rights under a mineral lease.

In Louisiana, as elsewhere, instruments are construed according to the sense of the terms used and the intention of the parties. These instruments clearly express an intention to convey to the transferees all the rights of the transferor under the lease; nothing in either instrument discloses an intention to create the relation of landlord and tenant.

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[4] The Commissioner had determined that the $350,000 paid by the Gulf Refining Company to Munhall in 1921, on behalf of the Baird partnership, was income to the latter, but the court below held to the contrary (R. 429) and judgment was entered in petitioner's favor on this issue.

The distinction between an assignment and a sublease in Louisiana is not substantially different from such distinction under the common law. Under either system, if the lessee transfers all of his rights and obligations under the lease without a right of reversion, the transfer is an assignment. The fact that a lessee's interest under a lease in Louisiana is of a different quality does not affect this question. Further, the fact that the purchase price is to be paid partly in oil extracted from the premises is not controlling. If the instrument effects a sale of the property right, the minerals paid thereunder are not rent or royalty, but purchase money.

In the instant case, the transfers, whether judged by the civil law of Louisiana or the common-law standards more generally applicable, effected assignments and not subleases. Hence, petitioner had disposed of all his depletable interest in the property against which an allowance is now sought.

**ARGUMENT**

The court below decided that under the law of Louisiana each of the instruments involved, the one executed by Smitherman and the other by Baird, effected a complete assignment of the property of the partnership in the lease assigned, and thus amounted to a sale of the assignor's interest. In so holding, it followed its earlier decisions concerning the construction of the same instruments.

*Waller* v. *Commissioner,* 40 F. (2d) 892, certiorari denied, 282 U. S. 889 (Smitherman instrument); *Herold* v. *Commissioner,* 42 F. (2d) 942 (Baird instrument).

Petitioner contends that each of the instruments is a sublease, and accordingly claims the right to deduct an allowance for depletion against his share of the two payments received by the Smitherman partnership from the Ohio Oil Company aggregating $4,000,000, and also against his share of the amount received by the Baird partnership from the Gulf Refining Company on account of the $325,000 to be paid out of sixty per cent of the oil produced. Revenue Act of 1921, Sec. 214 (a) (1), *infra,* p. 28.

Petitioner relies on *Murphy Oil Co.* v. *Burnet,* decided by this Court December 5, 1932 (No. 80, October Term, 1932), but that case can have no present application for it dealt with the right of a lessor to deduct depletion from a bonus paid upon the execution of an oil lease. The partnership of which petitioner was a member were neither lessors nor sublessors of oil properties. Upon execution of the instruments by Smitherman and Baird, petitioner and his associates parted with their entire interest in the premises and thereafter retained no depletable property against which an allowance could be made.[5] The petitioner apparently recog-

[5] The Revenue Act of 1921, Sec. 213 (a), c. 136, 42 Stat. 227, 237–238, provides that the gain, profits, or income from the sale of property is gross income. The basis for ascer-

nizes that if this was the case there is no basis for a depletion allowance to him and the question therefore is, Whether such instruments constituted assignments effecting a sale, or subleases.

## I

### UNDER THE LAW OF LOUISIANA, AS UNDER THE COMMON LAW, EACH OF THE INSTRUMENTS INVOLVED WAS AN ASSIGNMENT AND EFFECTED A SALE OF THE RIGHTS OF THE PARTNERSHIPS IN THE LEASES ASSIGNED. HENCE, PETITIONER RETAINED NO INTEREST IN THE PROPERTY AGAINST WHICH DEPLETION COULD BE ALLOWED

It is apparently undisputed that under the common law the instruments here in question would be construed as complete assignments of the leasehold rights. Petitioner insists that they would not be so construed under the law of Louisiana. We contend, however, that these instruments, under the civil as well as the common law, must be regarded as assignments.

In Louisiana, as in other jurisdictions, instruments are construed according to the sense of the terms used and the intention of the parties. See *Cooke* v. *Gulf Refining Co.*, 127 La. 592; *Bender* v. *Chew*, 129 La. 849. In the present case the language of the instruments themselves clearly shows

taining the gain derived from the sale of property acquired after February 28, 1913, is the cost. Revenue Act of 1921, Sec. 202 (a), 42 Stat. 227, 229. There is no provision which allows a deduction for depletion from the amount received upon a sale of property in mineral deposits, or for exhaustion in case of the sale of an incorporeal right.

an intention to transfer the entire property of the grantors in the leases. There is nothing in either instrument to indicate that the parties intended to create the relation of landlord and tenant.[6]

In the instrument executed by Smitherman, it is provided that, in consideration of the named sum and price, Smitherman "has and does by these presents sell, assign, set over, transfer, and deliver, without warranty or recourse, but with full subrogation of all rights and actions of warranty" the lease, in so far as it affects the area described; "To have and to hold unto The Ohio Oil Company, its successors and assigns forever, subject to the performance of the terms and covenants[7] * * *." (R. 31–32.)

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[6] Petitioner's twelfth requested finding of fact in the trial court was as follows: "12. That it was the intention of the partnership and of the Ohio Oil Company by said transfers to sublease the acreage covered." This request was granted by the District Court (R. 49), which refused, however, to conclude as a matter of law that the transfer from Smitherman to the Ohio Oil Company was a sublease (R. 55). The trial court's finding of fact was assigned as error by respondent on cross-appeal to the court below. (Br. 22.) The Circuit Court of Appeals apparently refused to accept the finding of the District Court, saying (R. 427): "There is nothing in either instrument to indicate that it was the intention of the parties to it to create the relationship of landlord and tenant." In any event, the finding is immaterial, since the parties unquestionably intended to make the particular instruments before the court, and the only issue presented for decision was the construction of the contracts, which presents a question of law and not a fact.

[7] This instrument covered only 120 acres. By the other instrument executed on the same day Smitherman trans-

In the instrument executed by Baird, the Gulf Refining Company was obligated to take possession of the property, equip and operate it at its own expense, and to make certain payments to Baird out of the oil produced. Baird agreed that upon the making of the payments specified he would "sell, assign, convey, and deliver" to the Gulf Refining Company the "entirety of the said mineral lease." (R. 316.) The instrument recited that upon that day Baird executed an assignment [8] to the company of "his entire interest in the said lease," to be deposited in escrow and to be delivered to the company when the obligation of the latter had been fulfilled. (R. 317.) It was further stated that the company loaned Baird $350,000 on the sole security of the lease, but without any personal liability of Baird, and without interest; the company, it was provided, was to reimburse itself out of sixty per cent of the oil produced, after the payment therefrom of $325,000 to Baird.

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ferred to the Ohio Oil Co. in substantially the same terms leases covering 17,000 acres. (R. 78, Exhibits Q and R, R. 249–288.) No claim has been made by petitioner for a depletion allowance with respect to those leases, although this assignment provides for a payment to the assignor of one-eighth of the oil produced in addition to a cash "price" of $370,000. (R. 287.)

[8] The assignment, although it was admittedly delivered, was not produced either in the present case or in *Herold* v. *Commissioner*, 42 F. (2d) 942 (C. C. A. 5th). The court below assumed that in form it really was an assignment. (R. 427.) There is no claim here that the contract was a mortgage or pledge, as was suggested by one of the other partners in the *Herold case*.

It is settled that in construing a contract the intention of the parties, as disclosed by the language they have used, is controlling. See *Heryford* v. *Davis,* 102 U. S. 235, 243–244, 245. The same rule is applied in construing oil and gas leases, both in the Federal courts, *Burkett* v. *Commissioner,* 31 F. (2d) 667 (C. C. A. 8th), certiorari denied, 280 U. S. 565, and in Louisiana, *Rives* v. *Gulf Refining Co.,* 133 La. 178, 182. See also *Murray* v. *Barnhart,* 117 La. 1023; and see *Bulkley* v. *Whited & Wheless, Ltd.*, 104 La., 125.

There is no doubt of the power of Smitherman and Baird to assign their rights under the mining leases. Revised Civil Code of Louisiana, Articles 2449, 2725, *infra,* pp. 33, 35; *Robertson* v. *Pioneer Gas Co.,* 173 La. 313; *Anse La Butte Oil & Mineral Co.* v. *Babb,* 122 La. 415; *Weatherly* v. *Baker,* 25 La. Ann. 229. Nor is it suggested that in the case of the instrument executed by Baird, the futurity of the transfer would prevent the agreement from constituting an assignment. A promise to sell has been held to amount to a sale, and either party has the right to specific performance. Revised Civil Code, Article 2462, *infra,* p. 33; *Girault* v. *Feucht,* 117 La. 276; *Kinberger* v. *Drouet,* 149 La. 986.

It is clear that Smitherman and Baird used terms expressive of an intent to convey to the transferees all the rights held by them under the leases. To overcome the plain effect of the words and the apparent purpose with which they were used, peti-

tioner argues that the law of Louisiana requires instruments like the present to be regarded as leases. He relies mainly upon *Roberson* v. *Pioneer Gas Co., supra,* which was decided after *Waller* v. *Commissioner, supra,* and *Herold* v. *Commissioner, supra,* but before the decision of the instant case.

In the *Roberson case* the question was whether a particular oil and gas lease was divisible and had been divided by an assignment of the lease affecting a specified part of the leased area. The court held that the lease was divisible, that part of it had been assigned, and that the drilling of a well upon the portion of the leasehold which was assigned could not save the lessee's rights with respect to the balance of the leasehold. In the course of the opinion the court stated that an assignment of a lease might be distinguished from a sublease in that in the former the assignor disposes of his entire interest in the lease, whereas in a sublease the sublessor retains some interest in the property "by imposing some obligation upon the sublessee in favor of the sublessor, such as an obligation to pay additional rent to the sublessor * * *" (p. 319). The court further remarked by way of general argument that payment of royalty is a payment of rent under the settled law of Louisiana, and hence that the reservation of an overriding royalty by a lessee in transferring his interest to another characterized the transaction as a sublease. Upon the basis of these statements peti-

tioner argues that since part of the payments under the instruments in suit are designated royalties, it follows that under the law of Louisiana the transactions now involved are subleases and not assignments.

The argument advanced by petitioner proceeds upon the erroneous assumption that the mere designation of payments as royalties necessarily determines their character as such. Cf. *Murray* v. *Barnhart, supra,* p. 1033. To call a part of the purchase price of a property right "rent" would not make it rent or change the position of a vendee to that of a tenant. "Royalties" paid under a lease may be regarded as rent, but there is a clear distinction between such payments made by a tenant to his landlord and payments made by the purchaser of land or of an interest in land out of minerals to be removed from the land under an instrument of sale or assignment. When there is a sale of the land or an assignment of a leasehold and it is provided that a part of the minerals, when extracted, are to be paid to the vendor, the minerals paid over under the agreement of sale must be regarded not as rent or royalty, but as purchase money. See 2 Thornton, Law of Oil and Gas (5th Ed.) Sections 363, 364. See also *Eldredge* v. *United States,* 31 F. (2d) 924, 926 (C. C. A. 6th); cf. *Jefferson Gas Coal Co.* v. *Commissioner,* 52 F. (2d) 120 (C. C. A. 3d); *Jamison Coal & Coke Co.* v. *Commissioner,* 24 B. T. A. 554, 570. The sales of oil and gas leases with provisions for part payment out of the proceeds

of the oil property is a familiar method of transferring such properties. See *Pugh* v. *Commissioner*, 49 F. (2d) 76 (C. C. A. 5th), certiorari denied, 284 U. S. 642; *Eldredge* v. *United States, supra; Ruth Iron Co.* v. *Commissioner*, 26 F. (2d) 30 (C. C. A. 8th); *Allen* v. *Phillips Petroleum Co.*, 13 F. (2d) 584 (C. C. A. 8th); *United Central Oil Corp.* v. *Helm*, 11 F. (2d) 760 (C. C. A. 5th), certiorari denied, 271 U. S. 686. In such cases payments measured by the yield of the oil properties should be regarded as installments of purchase price and not as royalties.[9]

We are not aware of any statute or of any decision in Louisiana which prohibits a sale of mineral rights with the provision that part payment of the purchase price shall be out of the yield of the property. On the contrary, the Revised Civil Code of Louisiana, Article 2786, *infra*, specifically recognizes that property may be sold with the rent reserved. Under these circumstances, we submit, the reference in *Roberson* v. *Pioneer Gas Co., supra*, to an obligation to pay royalty as determining the character of an instrument as a sublease must have meant royalty paid for the use of the property

[9] Petitioner states on page 23 of his brief that the Commissioner has allowed depletion with respect to the royalties received by the Smitherman and Baird partnerships. The circumstances under which such an allowance may have been made are not in the record, but if made, it was made erroneously and can not affect the decision of the issue presented here. With reference to subsequent years, the Commissioner has recognized his error and has now refused to make this allowance.

and not for its transfer. To interpret it as meaning that there can be no sale where the purchase price is stipulated to be paid in part out of the issues of the property would be to disregard the Civil Code (Article 2786, *supra*) and other decisions of the Louisiana Supreme Court upon which it relied in deciding the *Roberson case*.

In *Smith* v. *Sun Oil Co.*, 165 La. 907, the question was whether an instrument affecting a part of a leased area was an assignment, and hence operated to divide the lease, or was a sublease, so that production of oil thereunder prevented forfeiture as to the nonproducing balance of the leased area. The instrument was held to be a sublease. The court decided that the conditions of the contract which made it a sublease were that the lessee did *not dispose of all of its rights and obligations under the original lease on the 20 acres,* but granted to the sublessee an interest less than its own, and imposed upon him obligations under penalty of reversion to the sublessor (lessee), in addition to the obligations assumed in favor of the original lessor. The purpose of the sublease was to obtain immediate development and production on the leased premises in order to prevent a forfeiture of the original lease, and it was stipulated that the sublessee should commence drilling within thirty days, and drill and complete all wells necessary to protect the lines. For any failure in this respect the sublessee would forfeit all of his rights and they would revert and revest in the sublessor. The sublessee

was to pay a royalty to the sublessor, in addition to the royalty payable to the original lessor; and it was stipulated that whenever the sublessee should cease operations, all of his rights should revert to and revest in the sublessor. The court cites and quotes from numerous writers, on both the civil and the common law, who point out the distinction between an assignment and a sublease. From these authorities it is apparent that such distinction is not materially different under the two systems. Under each system, if the lessee grants his entire interest under the lease with respect to the part covered by the grant and without any reversion to lessee, it is an assignment; if the lessee grants an interest less than his own, it is a lease.[10]

*Smith* v. *Sun Oil Co., supra,* was cited with approval in *Johnson* v. *Moody,* 168 La. 799, although the latter case was decided upon another point.

The *Smith* and *Johnson cases* were relied upon by the court in the *Roberson case.* We submit that they support the conclusion that the present instruments created assignments and not subleases. It is true that in the *Roberson case* the Louisiana court, discussing the *Smith* and *Johnson cases,* stated that the reference to penalty of reversion in the latter was not intended in the technical sense

[10] Under the common law see *Craig* v. *Summers,* 47 Minn. 189; *Davidson* v. *Minnesota Loan & Trust Co.,* 158 Minn. 411; *Stewart* v. *Long Island R. R. Co.,* 102 N. Y. 601; *Gillette Bros., Inc.* v. *Aristocrat Restaurant, Inc.,* 239 N. Y. 87, 90; *In re Bayley,* 177 Fed. 522 (W. D. Pa.); 1. Tiffany, Landlord and Tenant, pp. 907–909, 917.

of the common law, but that it contemplated the reversion of the rights of occupancy or use of the property. This distinction is based upon the difference between the common law and the civil law with reference to the nature of a lessee's interest; in the former a lessee has an estate in the leased property, whereas under the civil law the lease grants only the right to the use or enjoyment of the property. See *Viterbo* v. *Friedlander,* 120 U. S. 707; Revised Civil Code of Louisiana, Articles 2669, 2674; *Wemple* v. *Nabors Oil & Gas Co.,* 154 La. 483. But in applying the rule laid down by the court the quality of the right of the lessee is not important. The question is whether he has by his grant divested himself of his leasehold interest in its entirety. If he has, the grant would be an assignment under either system.

Petitioner cites *Logan* v. *State Gravel Co.,* 158 La. 105, and *Commissioners* v. *Pure Oil Co.,* 167 La. 801, as holding that royalty under oil and gas leases is always rent. We submit that those decisions are not applicable here, as the issue in the instant case is whether or not there was a *sale* of the lessee's property rights. If the instruments executed by Smitherman and Baird effected sales, there is no necessity of noting what would be the character of the royalty payments if the instruments had effected leases. Neither of the above cases holds that the relationship of landlord and tenant existed *because* the royalty was rent. The distinction made by the court in *Logan* v. *State*

*Gravel Co.* was that in a "sale," ownership of the thing sold passes out of the vendor forever, while in the case of a lease the ownership of the thing leased remains in the lessor (landlord) and the tenant acquires only the use or enjoyment of the thing leased and must return it at the end of the term. The instrument there in question conformed with the latter conditions and was held to be a lease for that reason. The basic holding of the two cases last cited is that the terms of the contracts created the relation of landlord and tenant, with the necessary concomitant that payments made by tenant to landlord were rent, whatever term may have been used to describe them. In the present case, however, the fundamental condition—that is, the relation of landlord and tenant—is absent, and the payment *a fortiori* can not be rent.

It is further suggested that because the instruments in question provided for payment to the respective grantors of part of the oil produced they could not be sales under Articles 2439, 2464, and 2671, of the Revised Civil Code of Louisiana, *infra,* pp. 33, 34, 35, which require, among other things, that the consideration for a sale must be certain. The same elements are required in a contract of lease as are required by Article 2439 in the case of a sale, to wit, the thing, the price, and the consent. (Article 2670, *infra,* p. 34.) Likewise, in the case of a lease there must be a fixed price. (Article 2671, *infra,* p. 35.) It would seem plain that these statutes provide merely that the measure

of the consideration must be agreed upon and not left to future bargaining—not that it must be capable of exact mathematical computation at the time of entering into the contract.[11]

Petitioner also suggests that the grantors would have the right to cancel the contracts upon failure of the grantees to pay the "rent" (royalties) stipulated. This contention assumes the very thing that is now the subject of dispute, since it would be sound only if the grantees are lessees and not vendees. There is nothing in the wording of either instrument to sustain the argument. Baird agreed to transfer his "entire interest in the said lease." (R. 317.) Smitherman assigned all of his rights in the lease to the Ohio Oil Company to have and to hold forever. (R. 32.) *Louisiana Oil Refining Corporation* v. *Cozart,* 163 La. 90, and Article 2712, *infra,* p. 35, cited by petitioner, refer only to lessees and hence are not in point.

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Under the law of Louisiana and under the law that obtains generally in jurisdictions that apply the criteria of the common law, the instruments executed by Smitherman and Baird must be regarded as assignments and not as leases. Presumably the local law would control in this case.

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[11] Article 2464 states that the price of the sale "ought to consist of a sum of money, otherwise it would be considered as an exchange." It is wholly immaterial in the present case whether there was a sale or an exchange of the property in question, since in either event the ownership of the thing sold or exchanged passed from the vendor to the purchaser.

See *Burnet* v. *Harmel,* decided November 7, 1932 (No. 26, October Term, 1932). But whichever law is to be applied the result is the same, and we submit that the transfers in question effected "a sale or other disposition of property" within the meaning of Section 202 (a) of the Revenue Act of 1921, *infra,* p. 28, and that the Commissioner therefore correctly applied that section in computing the gain derived, without giving the petitioner the allowance for depletion which he now claims.

## CONCLUSION

It is respectfully submitted that the decision of the court below was correct and should be affirmed.

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DECEMBER, 1932.

# APPENDIX

## STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1921, c. 136, 42 Stat. 227, 229, 239, 245:

> SEC. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; * * *
>
> SEC. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * * *
>
> (10) In the case of mines, oil and gas wells, * * * a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: * * * *Provided further,* That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of the discovery, or within thirty days thereafter: *And provided further,* That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made, except where such net income so computed is less than the depletion allowance based on

cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

SEC. 218. (a) That individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. There shall be included in computing the net income of each partner his distributive share, whether distributed or not, of the net income of the partnership for the taxable year, * * *.

Treasury Regulations 62:

ART. 201. *Depletion of mines, oil and gas wells; depreciation of improvements.*—
* * *

* * * * *

(h) Depletion allowance in case of discovery: The deduction for depletion in case of a discovery can not exceed the net income computed without allowance for depletion, from the property upon which the discovery is made, except where and to the extent that such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913. Net income is the gross income from the sale of all mineral products and any other income incidental to the operation of the property for the production of the mineral products, less operating expenses, including depreciation on equipment, and taxes, but excluding any allowance for depletion. If the mineral products are not sold as raw material but are manufactured or converted into a re-

fined product, then the gross income shall be assumed to be equivalent to the market or field price of the raw material before conversion. Operating expenses, depreciation, and taxes on the property upon which the discovery is made, should be applied against the gross income from the same property on the basis of actual expenditures, but if the records for the year 1921 are in any case inadequate, allocation of such expenditures for that year may be made on the basis of the ratio of (1) the number of wells operated on the property on which the discovery is made to (2) the total number of wells operated in the operating division in which the discovery is included.

ART. 203. *Amount returnable through depletion and depreciation deductions in the case of lessee.*—(a) In the case of a lessee, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value as of the basic date of the lessee's equity in the property plus (2) subsequent allowable capital additions but minus (3) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

(b) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(c) The value of a lessee's equity, if acquired prior to March 1, 1913, is the value of his interest in the mineral as of that date.

(d) The value of a lessee's equity in a proven mineral property acquired on or after March 1, 1913, is its cost.

(e) The value of a lessee's equity in a discovery on or after March 1, 1913, is the fair market value at date of discovery or within 30 days thereafter, of his equity in the mineral discovered.

ART. 204. *Amount returnable through depletion and depreciation in case of lessor.*— (a) In the case of a lessor, the amount remaining in any year returnable through depletion and depreciation deductions is (1) the value of his equity in the property at the basic date minus (2) depletion and depreciation sustained, whether legally allowable or not, from the basic date to the taxable year, plus (3) subsequent allowable capital additions, and minus (4) the value of the land at the basic date for other purposes than mineral production and the residual value of other property at the end of operations. The amount returnable through depletion is the total capital remaining less the sum recoverable through depreciation.

(b) The value of the equities of lessor and lessee shall be computed separately, but, when determined as of the same basic date, shall together never exceed the value at that date of the property in fee simple.

(c) The value of the lessor's equity in the case of a mineral property not under lease on March 1, 1913, but subsequently leased, is the en bloc value of the mineral in the ground on March 1, 1913, and will, in the absence of satisfactory evidence to the contrary, be presumed not to exceed the value as of March 1, 1913, of the royalties to be expected under the lease.

* * * * *

(f) The value of a lessor's equity in a mineral property when acquired on or after March 1, 1913, is its cost.

(g) The value of a lessor's equity in a discovery on or after March 1, 1913, is the fair market value at the date of discovery, or within 30 days thereafter, of his equity in the mineral discovered.

ART. 215. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus or other sum in addition to royalties, such bonus or other sum shall be regarded as a return of capital to the lessor, but only to the extent of the amount remaining to be recovered through depletion by the lessor at the date of lease. If the bonus exceeds the amount remaining to be recovered, the excess and all the royalties thereafter received will be income and not depletable. If the bonus is less than the amount remaining to be recovered by the lessor through depletion, the difference may be recovered through depletion deductions based on the royalties thereafter received to the extent that such deductions are legally allowable. The bonus or other sum paid by the lessee for a lease made on or after March 1, 1913, will be his value for depletion as of date of acquisition.

ART. 215. [As amended by T. D. 3938 (1926), C. B. V-2, p. 117.] *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount

remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

Merrick's Revised Civil Code of Louisiana, Third Edition:

ART. 2439. *Definition.*—The contract of sale is an agreement by which one gives a thing for a price in current money, and the other gives the price in order to have the thing itself.

Three circumstances concur to the perfection of the contract, to wit: the thing sold, the price, and the consent.

ART. 2449. *Incorporeal Things Included.*—Not only corporeal objects, such as movables and immovables, livestock and produce, may be sold, but also incorporeal things, such as a debt, an inheritance, the rights, titles and interests to an inheritance or to any parts thereof, a servitude or any other rights. (As amended by Act 126 of 1888, p. 186.)

ART. 2462. *A Promise to Sell,* when there exists a reciprocal consent of both parties as to the thing, the price and terms, and which, if it relates to immovables, is in writing, so far amounts to a sale, as to give either party the right to enforce specific performance of same.

One may purchase the right or option to accept or reject, within a stipulated time, an offer or promise to sell, after the purchase of such option, for any consideration therein stipulated, such offer, or promise can not be withdrawn before the time agreed upon; and should it be accepted within the time stipulated, the contract or agreement to sell, evidenced by such promise and acceptance, may be specifically enforced by either

party. (As amended and reenacted by Act 27 of 1920.)

ART. 2464. *Price must be Certain and Substantial, and Agreement Serious.*—The price of the sale must be certain, that is to say, fixed and determined by the parties.

It ought to consist of a sum of money, otherwise it would be considered as an exchange.

It ought to be serious, that is to say, there should have been a serious and true agreement that it should be paid.

It ought not to be out of all proportion with the value of the thing; for instance the sale of a plantation for a dollar could not be considered as a fair sale; it would be considered as a donation disguised.

ART. 2471. *Conditional Sales.*—A sale, made with a suspensive condition, does not transfer the property to the buyer, until the fulfillment of the condition.

If the thing be destroyed before this happens, the loss is sustained by the seller.

If the thing be only deteriorated, when the condition is accomplished, the buyer has the choice either to take it in the state in which it is, or to dissolve the contract.

If it has undergone any improvement without the agency of the seller, the buyer has the advantage of this improvement, without having to pay any increase of price.

ART. 2669. *Lease or Hire Defined.*—Lease or *hire* is a synallagmatic contract, to which consent alone is sufficient, and by which one party gives to the other the enjoyment of a thing, or his labor, at a fixed price.

ART. 2670. *Essentials of.*—To the contract of lease, as to that of sale, three things are absolutely necessary, to-wit: the thing, the price, and the consent.

ART. 2671. Id. *The Price* should be certain and determinate, and should consist of money. However, it may consist in a certain quantity of commodities, or even in a portion of the fruits yielded by the thing leased.

ART. 2674. *Lease of Things.*—To let out a thing is a contract by which one of the parties binds himself to grant to the other the enjoyment of a thing during a certain time, for a certain stipulated price which the other binds himself to pay him.

ART. 2712. *Non-Payment of Rent.*—The lessee may be expelled from the property if he fails to pay the rent when it becomes due.

ART. 2725. *Sub-Lease.*—The lessee has the right to underlease, or even to cede his lease to another person, unless this power has been expressly interdicted.

The interdiction may be for the whole, or for a part; and this clause is always construed strictly.

ART. 2786. *Resale.*—A thing sold and paid for may be alienated absolutely and unconditionally; but if it be sold with a rent reserved, it remains perpetually subject to the rent, into whatsoever hands it may pass.

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